RAILROAD COMMISSION OF TEXAS
OFFICE OF GENERAL COUNSEL

OCTOBER 20, 1997

PROPOSAL FOR DECISION
OIL & GAS DOCKET NO. 02-0216535
DISTRICT 2

APPLICATION OF MERRIMAC ENERGY CORP. FOR FORMATION OF A POOLED UNIT PURSUANT TO THE MINERAL INTEREST POOLING ACT, HORADAM (2200 MIOCENE) FIELD, VICTORIA COUNTY, TEXAS.

APPEARANCES:	**REPRESENTING:**
APPLICANT -	
Lloyd Muennink, Attorney Shain McCaig, President Charles Graham, III, Consulting P.E.	Merrimac Energy Corp.
PROTESTANT -	
George C. Neale, Attorney James M. Doherty, Attorney Rick Johnston, Petroleum Engineer Luther Horadam	Henry L. Horadam

PROCEDURAL HISTORY

Application Filed:	June 11, 1997
Original Notice of Hearing:	June 20, 1997
Hearing Held:	September 22, 1997
PFD Circulated	October 20, 1997
Heard by:	Colin K. Lineberry, Hearings Examiner Donna K. Chandler, P.E., Technical Examiner

STATEMENT OF THE CASE

Merrimac Energy Corp. ("Merrimac" or "applicant") seeks an order pursuant to the Mineral Interest Pooling Act ("MIPA"), TEX. NAT. RES. CODE ANN. § 102.001, *et seq.*, creating the Horadam Unit in the Horadam (2200 Miocene) Gas Field ("subject field") by forcing the pooling of productive acreage in applicant's Henry Heinrich and Hogan Leases with productive acreage from protestant Henry Horadam's Horadam Bros. Lease (collectively, the "subject leases"). Well No. 1 on the Horadam Bros. Lease ("subject well") is the only currently producing well in the Horadam (2200 Miocene) Field.

The hearing in this docket was held on September 22, 1997. The applicant presented two witnesses in support of its case. Protestant Horadam cross-examined applicant's witnesses and presented its own testimony and exhibits.

MIPA OFFER REQUIREMENT

The MIPA, which was enacted on March 4, 1965 (effective August 29, 1965), provides for the compulsory pooling of productive acreage in reservoirs discovered on or after March 8, 1961, under certain limited circumstances. The act is intended to encourage voluntary pooling and "is more aptly described as 'an Act to encourage voluntary pooling - rather than an Act to provide compulsory state action.'"[1] The MIPA contains a jurisdictional requirement, unique among state compulsory pooling statutes, that the applicant make a fair and reasonable offer to pool prior to applying for compulsory pooling through the Commission.[2] If the applicant failed to make a fair and reasonable offer to voluntarily pool, the Commission lacks jurisdiction over the MIPA application and must dismiss it.[3] The phrase "fair and reasonable offer to pool voluntarily" is not defined in the MIPA and the Commission has discretion in determining whether an offer qualifies under the terms of the statute.[4] However, the offer must be fair and reasonable from the perspective of the party being compelled to pool[5] based on a consideration

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[1] *Railroad Commission of Texas v. Pend Oreille Oil & Gas Co.*, 817 S.W.2d 36, 40 (Tex. 1991) *quoting*, Smith, *The Texas Compulsory Pooling Act*, 43 Texas L.Rev. 1003, 1009 (1965).

[2] *Id.* at 40 [citations omitted].

[3] *Id.* at 40; *Carson v. Railroad Commission*, 669 S.W.2d 315, 318 (Tex. 1984); *Buttes Resources Co. v. Railroad Commission*, 732 S.W.2d 675, 678 (Tex. App. -- Houston[14th Dist] 1987, writ ref'd n.r.e); MIPA § 102.013(b).

[4] *Railroad Commission v. Pend Oreille Oil & Gas Co.*, 817 S.W.2d at 40.

[5] *Railroad Commission v. Broussard*, 755 S.W.2d 951, 952 (Tex. App. -- Austin 1988, writ denied); *Windsor Gas Corp. v. Railroad Commission*, 529 S.W.2d 834, 837 (Tex. Civ. App. -- Austin 1975, writ dism'd as moot).

of the relevant facts existing at the time of the offer.[6] The MIPA does not require that the offeree make a counter-offer, but the response (or lack of response) by the offeree is a factor to consider in determining whether an offer is fair and reasonable.[7]

HISTORY OF DISPUTE

The applicant and protestant have a lengthy and contentious history with regard to the reservoir ("subject reservoir") now designated by the Commission as the Horadam (2200 Miocene) Field. Merrimac completed its Heinrich No. 2 in the subject reservoir in 1996. Merrimac reported to the Commission that the Heinrich well was completed in the Aloe (2200) Field. At that time, the Heinrich No. 2 was the only well in the Aloe (2200) Field, which was discovered in 1951.

Rule 37 Hearing

Subsequently, Horadam applied for a Rule 37 exception to plugback Well No. 1 on its adjacent Horadam Bros. Lease (the subject well) to the Aloe (2200) Field.[8] Because of its irregular shape, the 195-acre Horadam Bros. Lease had no regular location. By the time of the November 1, 1996 hearing on Horadam's Rule 37 application ("Rule 37 Hearing"), Merrimac's Heinrich No. 2 well had watered out and ceased producing, but was still carried as the only well in the Aloe (2200) Field.

New Field Designation and Adoption of Field Rules

After the Rule 37 Hearing (but before a PFD was issued), Merrimac applied for and received a new field designation for its watered out well changing the commission-designated name for the subject reservoir from the Aloe (2200) to the Horadam (2200 Miocene) Field and changing the discovery date for the subject reservoir from 1951 to 1996. As noted above, the MIPA only applies to fields discovered on or after March 8, 1961. During the same time period Merrimac, in spite of the fact that its well was watered out and no longer producing, applied for and obtained, as the operator of the only well in the subject reservoir, field rules requiring 120 acre proration units.

A PFD was issued recommending that the requested Horadam Rule 37 exception be granted on February 19, 1997. Merrimac then filed exceptions asserting, among other claims, that the exception should be denied because Horadam had applied for the wrong field (i.e. applied

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[6] *Railroad Commission v. Pend Oreille Oil & Gas Co.*, 817 S.W.2d at 41; *Carson v. Railroad Commission*, 669 S.W.2d at 318.

[7] *Railroad Commission v. Pend Oreille Oil & Gas Co.*, 817 S.W.2d at 43; *American Operating Co. v. Railroad Commission*, 744 S.W.2d 149, 154 (Tex. App. -- Houston{14th Dist.] 1987, writ denied).

[8] The Case was docketed as Rule 37 Case No. 0212772.

using the Aloe (2200) designation assigned to the subject reservoir at the time of the hearing and not the new name subsequently obtained by Merrimac) and had not assigned enough acres to the well (i.e. assigned the 40 acres required at the time of its application rather than the 120 acres required by the temporary field rules subsequently obtained by Merrimac). An order granting Horadam's requested Rule 37 became final on April 22, 1997 when Merrimac's motion for rehearing was denied by the Commission.

First MIPA Hearing

On April 3, 1997, Merrimac filed an application pursuant to the MIPA to force pool with the subject well. The application was docketed as Oil & Gas Docket 02-0215708 and was set for hearing on May 14, 1997 ("First MIPA Hearing"). Horadam filed a timely notice of protest and requested a postponement. Merrimac opposed the postponement and asserted that any delay in the hearing would give Horadam an unjust advantage. Horadam's request for postponement was denied by a written ruling on May 12.

At the call of the hearing on May 14, Horadam appeared with counsel and expert witnesses and announced "ready." Merrimac's counsel announced that he was not ready to go forward and requested that Merrimac's application be dismissed without prejudice to refiling. Horadam's counsel objected to the withdrawal and requested that any dismissal be with prejudice to refiling. The Commission's General Counsel signed an order dismissing the First MIPA Hearing without prejudice on May 15, 1997. Horadam timely filed an interim appeal of the order seeking a dismissal with prejudice. Horadam's interim appeal was subsequently overruled by operation of law.

Current MIPA Application

While Horadam's interim appeal was still pending, Merrimac filed the current MIPA application, again seeking to force pool its Henry Heinrich and Hogan Leases with Henry Horadam's Horadam Bros. Lease. This matter was originally set for July 28, 1997 but was ultimately heard on September 22, 1997 after Horadam was granted successive continuances first due to a scheduling conflict for his attorney, then due to the hospitalization of a witness, and a final five day postponement because of a scheduling conflict. It is undisputed that the subject field has a strong water drive component, that the Horadam Bros. No. 1 is currently the only producing well in the field and that the Horadam well will drain the entire reservoir.

APPLICANT'S EVIDENCE

Applicant Merrimac presented a net pay isopach of the subject field reflecting that the field is comprised of 89 productive surface acres: 37 acres on protestant's Horadam Bros. Lease and 52 cumulative acres on Merrimac's leases. The 52 acres on the Merrimac leases are comprised of 21 acres from the Hogan Lease and 31 net acres on the Heinrich Lease. Merrimac's witnesses testified that the Heinrich Lease originally contained 50 productive acres but that only 31 productive acres remain because 19 acres have been drained by Merrimac's Heinrich No. 2, which produced 20 million cubic feet of gas from the subject field before it watered out. Based on its calculations of productive surface acres, Merrimac's offer proposed

allocating production 41.6% to Horadam and 58.4% to Merrimac and the working interest owners in the Hogan and Heinrich Leases.

Merrimac presented evidence that it made an offer to Horadam to voluntarily pool the subject leases by letter dated May 16, 1997 and delivered to Horadam's counsel on May 20, 1997. A proposed joint operating agreement ("JOA") was included with the offer letter. The offer letter set out the proposed allocation of production based on Merrimac's determination of productive surface acreage. Other terms of the pooling proposal as described in the offer letter and JOA were somewhat ambiguous or difficult to decipher. However, the testimonial evidence presented by Merrimac clarified many of the unclear terms of the proposal. Shain McCaig, president of Merrimac, testified that Merrimac was proposing that it be the designated operator of the pooled unit. McCaig also testified that Merrimac was offering to pay its proportionate share of the actual costs incurred by Horadam to recomplete the subject well and to connect the well to a pipeline. McCaig indicated that Merrimac was not offering to pay any part of the value of the lease or of the wellbore and existing facilities because Horadam received the lease and well as part of a retirement package and did not have any out of pocket cost in acquiring them.

McCaig estimated that it would cost $60,000 to $65,000 to drill a new well to the subject field. Merrimac's engineering expert agreed that $65,000 was a reasonable estimate of the cost to drill a new well to the subject field. He also testified, on cross-examination, that Merrimac has two existing wells that could be plugged back to the subject field but noted that this would require abandonment of the existing completions.

PROTESTANT'S EVIDENCE

Protestant Horadam's expert witness criticized Merrimac's mapping of the structural contours of the field and asserted that properly honoring all data points reduced the productive acreage in Merrimac's Heinrich Lease to 12.4 productive acres. The water encroachment zone resulting from drainage by Merrimac's Heinrich No. 2 mapped by Merrimac in its net pay isopach map does not strictly follow structural contours. Horadam's expert testified that the encroachment zone would ordinarily be expected to follow structural contours and that, if it did, the number of productive surface acres on Merrimac's Heinrich Lease would be reduced. Horadam also asserted that reservoir volume (in acre-feet) was a more equitable method of allocating production than the surface acreage basis used by Merrimac. Horadam's expert calculated that 50.98% of reservoir volume is within the boundaries of the Horadam Bros. Lease and 49.02% is within the boundaries of the Merrimac leases (26.23% under the Hogan Lease and 22.79% under the Heinrich Lease).

Horadam presented evidence that it's Horadam Bros. No. 1, the well at issue, was originally completed as a producer in the Aloe (Catahoula) Field in June of 1985. Horadam recompleted the well in the subject field on June 11, 1997. Horadam's total expenditures in recompleting the well and tying into a pipeline, including fees incurred in permitting the well over the protest of Merrimac, were $45,325. Horadam's expert estimated that it would cost $90,000 to drill and case a new well to the subject field. On cross-examination, Horadam's expert testified that the subject well is currently only draining Merrimac's structurally lower Heinrich Lease and not its Hogan Lease.

Horadam asserted that Merrimac's pooling offer was not fair or reasonable. In support of this assertion, Horadam pointed out numerous discrepancies, omissions, and contradictions in the offer, particularly in the proposed JOA, including: the cover page, purporting to set out the working interests, totals 100% but does not include Horadam; a table of working interests attached as Exhibit A contains a different list of working interests, also totaling 100%, but still does not include Horadam; the "contract area" is described as the Horadam Lease without any reference to the Hogan and Heinrich leases; references to an unrelated 1994 Operating Agreement; references to an Exhibit A-1 that does not exist; the listing of "leases subject to this agreement" does not include the Horadam Bros. Lease but does include other, apparently unrelated leases; and, the offer letter does not have a signature block for Horadam to indicate his acceptance of the offer. Horadam asserted that the various omissions and discrepancies (and particularly the omission of any description of the Horadam Bros. Lease or designation of the Horadam share of the unit in the JOA) render the purported offer unintelligible and *per se* unreasonable. Horadam also asserted that the substantive terms of the offer were unreasonable because Merrimac would be designated operator of the unit and because Merrimac was not offering any compensation to Horadam for the value of the subject well's wellbore and existing casing, which would cost between $65,000 and $90,000 to replace.

EXAMINERS' OPINION

The examiners agree that the voluntary pooling offer transmitted by Merrimac to Horadam was flawed and difficult to decipher on a number of key points due to the various errors and omissions pointed out by Horadam. Many of the problems seem to have just been drafting errors, however, and it appears that most of the ambiguities could have been cleared up if Horadam had made a counter-offer or simply requested clarification. In the examiners' opinion, the Commission should be reluctant to find an ambiguous and/or poorly drafted offer unreasonable for those reasons alone when the MIPA offeree made no attempt to negotiate or clarify the terms of the offer. It is unnecessary to resolve that issue, however, because at least two of the substantive terms of the offer are unreasonable under the facts existing at the time the offer was made.

Merrimac's offer was unreasonable in that it proposed that Merrimac operate the unit. The offer letter itself is arguably ambiguous as to operatorship.[9] However, Merrimac states positively three separate times that it proposes that it be the operator of the unit. Although there are references to the possibility of Horadam operating, these are stated as contingent possibilities - - there is no unrestricted offer to allow Horadam to continue as operator. Any possible

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[9] In the same paragraph of the letter Merrimac states: 1) "Merrimac proposes that Merrimac be designated as Operator of the Horadam No. 1 well ..."; 2) "... if this is not considered reasonable then **possible** joint ownership could be **negotiated**."; 3) "Attached is an Operating Agreement whereby Merrimac Energy Corp. proposes to operate the Horadam No. 1 Well for the proposed 89 acre Voluntary Unit."; 4) "...**if** Henry Horadam can demonstrate that he is in good health and capable of operating the well, **then** Merrimac **could** agree to Horadam being the Operator ..."; 5) "... Merrimac Energy Corp. proposes that Merrimac operate the Horadam No. 1 Well ..." [emphasis added].

ambiguity as to who Merrimac is proposing as operator is resolved by the terms of the JOA and the testimony at hearing. The JOA indicates that Merrimac is the designated operator of the unit in at least four separate places. At hearing, Merrimac's president testified that Merrimac's proposal was that it operate the unit and did not mention any possibility that Horadam would be designated operator of the unit. Further, Merrimac's application to the Commission for forced pooling requested that Merrimac be appointed operator of the unit and Merrimac's counsel reiterated that Merrimac would be the operator in his closing statement.

Under Merrimac's proposal Horadam, the owner of the minerals and the surface of the Horadam Bros. Lease and the operator who successfully recompleted the well, would be required to cede operatorship and control of his well on his property to Merrimac. Further, under the literal terms of the proposed JOA, Horadam could never become operator of the unit unless designated as successor operator by Merrimac. As noted above, Merrimac was only able to maintain an MIPA action because it obtained a new field designation for the subject reservoir after its only well had already ceased production and Merrimac has vigorously protested Horadam's attempts to permit this well. Given Horadam's ownership of the minerals and surface, his recompletion of the well, his current operatorship, and the continuing conflicts between these parties, a pooling offer requiring Horadam to surrender operatorship of the subject well to Merrimac is clearly not reasonable from the perspective of Horadam.

The Merrimac proposal was also unreasonable in that Merrimac is not offering to pay any portion of the value of the wellbore and downhole equipment which Horadam would be forced to contribute to the unit.[10] Merrimac apparently justifies this omission on the ground that Horadam did not have any "actual cost out of pocket" for the well. There is no authority for this limitation on Merrimac's offer to reimburse Horadam.[11] The right to operate the well and the physical wellbore and equipment clearly have substantial value to anyone seeking to recover the reserves in the subject field. Obviously, a mechanically sound wellbore and the legal right to operate that well bore (i.e. required permits) are necessary to produce the reserves in the subject field. By the parties' estimates, it would cost between $65,000 and $90,000 to replace the subject well with a new well. The fact that Horadam did not pay cash "out of pocket" for the well is irrelevant. He would be contributing a valuable asset to the pooled unit and is entitled to a proportionate contribution from Merrimac since it would be sharing in the production made possible by the well. Merrimac's president made it abundantly clear that Merrimac's pooling offer did not include an offer to compensate Horadam for any portion of the value of the well.

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[10] The offer letter is, again, somewhat ambiguous as to whether Merrimac is offering to pay anything for the value of the well. Merrimac's president testified unequivocally at the hearing, however, that Merrimac's offer did not include any payment for the value of the well or lease.

[11] MIPA § 102.052 does refer to ordering the reimbursement of "all actual and reasonable drilling, completion and operating costs ..." This section however, addresses what must be contained in a Commission order forcing pooling, not what constitutes a reasonable offer. Further, the section appears to apply only to prospective drilling as it refers to owners who elect not to pay costs in advance and, in any event, there is no indication that the items set out are an exclusive list of reimbursable items.

This omission clearly rendered Merrimac's voluntary pooling offer unreasonable from Horadam's perspective or from any objective perspective.

As Merrimac has not made a fair and reasonable offer to pool voluntarily, the Commission is required by statute and case law to dismiss this application for lack of jurisdiction. The examiners recommend adoption of the following proposed findings of fact and conclusions of law:

FINDINGS OF FACT

1. Notice of the hearing was given at least 30 days prior to the hearing to all interested persons entitled to notice.

2. Merrimac Energy Corporation ("Merrimac") applied on June 11, 1997 for a Commission order pursuant to the Mineral Interest Pooling Act ("MIPA")[TEX. NAT. RES. CODE ANN. § 102.001 *et seq.*] forcing the pooling of Merrimac's Henry Heinrich and Hogan Leases with the Horadam Bros. Lease operated by Henry Horadam ("Horadam") in the Horadam (2200 Miocene) Field, Victoria County, Texas. The application is protested by Horadam.

3. The reservoir at issue was approved as a new field with a discovery date of February 16, 1996 and denominated the Horadam (2200 Miocene) on December 9, 1996. The size and shape for proration units in the field were established by temporary field rules adopted on February 11, 1997. The field rules prescribe 120 acre proration units.

4. Horadam, who is the fee owner of the surface and minerals on the Horadam Bros. lease, currently operates the only producing well in the Horadam (2200 Miocene), Well No. 1 on the Horadam Bros. Lease.

5. Merrimac's Henry Heinrich and Hogan Leases are adjacent to the Horadam Bros. Lease. The Horadam (2200 Miocene) Field underlies the Henry Heinrich, Hogan and Horadam Bros. Leases.

6. Merrimac made a voluntary offer to Horadam to pool Merrimac's Henry Heinrich and Hogan Leases with Horadam's Horadam Bros. Lease on or about May 20, 1997. Under Merrimac's proposal for voluntary pooling:

   a. Horadam would have to surrender operatorship of his producing well and Merrimac would take over as operator of the well.

   b. Merrimac would not reimburse Horadam for any portion of the value of the existing wellbore and casing in Well No. 1 on the Horadam Bros. Lease, the only producing well in the proposed pooled unit.

CONCLUSIONS OF LAW

1. Proper notice of hearing was timely given to all persons legally entitled to notice.

2. Merrimac has not made a fair and reasonable offer to pool the leases at issue voluntarily.

3. The Commission lacks jurisdiction to consider the application and it should be dismissed pursuant to MIPA § 102.013(b).

RECOMMENDATION

The examiners recommend that the subject application be dismissed in accordance with the attached final order.

Respectfully submitted,

Colin K. Lineberry
Hearings Examiner

Donna K. Chandler, P.E.
Technical Examiner